A Work Project, presented as part of the requirements for the Award of a Master's Degree in Finance from the Nova School of Business and Economics.

SELECT MEDICAL HOLDINGS CORP – LEVERAGED BUYOUT

Mariana Serra Flora Ramos
41078

Work Project carried out under the supervision of:

Luís Mota Duarte

04.01.2021

Abstract:

The present Investment Committee Paper focuses on a potential LBO transaction of Select Medical Holdings Corp, one of the key companies of United States' physical therapy industry operating in inpatient and outpatient segments. Group H performed a company and market overview to assess the eligibility of Select Medical as a Leveraged Buyout aspirant. Also, value creation strategies were matured, considering a forecasted operating model. After this, the group evaluated the company by building a model with an optimal capital structure and returns for the exit year and assessing potential exit options.

Keywords:

Private Equity, LBO, Select Medical, Physical Therapy

Disclaimer:

The following Work Project was elaborated by a group a students from the Master in Finance from NOVA School of Business and Economics. We solemnly pledge that the presented Work Project was done accordingly to the University's Code of Honor, being entirely our own. This Investment Committee Paper was developed for academic purposes only thus we do not take any responsibility for legal, investment or other decisions built upon this paper. The data used on the Work Project was completely gathered from publicly available sources.

The Work Project is composed by three interdependent parts, as such, for a complete understanding of the Investment Committee Paper, please refer to "Select Medical Holdings Corp – Investment Committee Paper" and "Select Medical Holdings Corp – Private Equity Buyout".

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

Select Medical Holdings

Investment Committee Paper

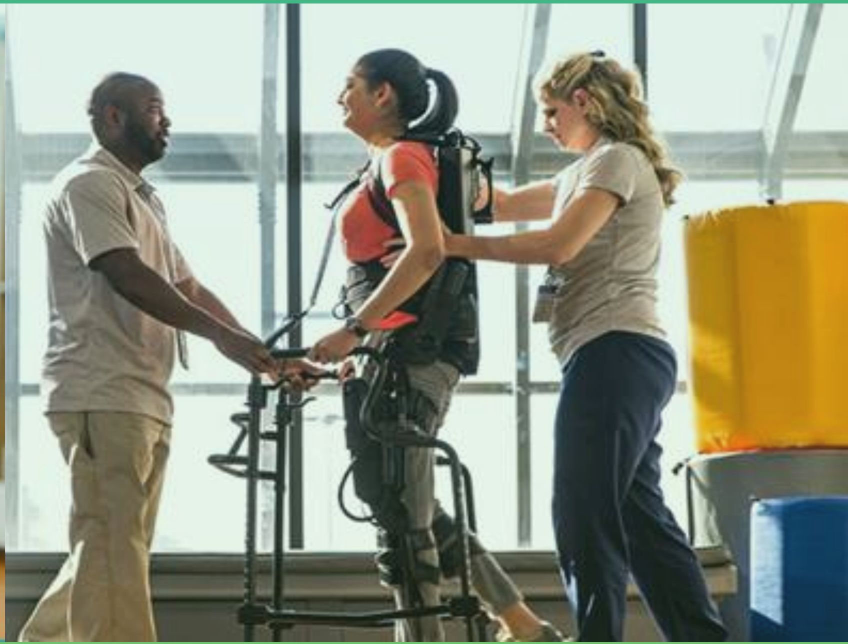
Academic Year 2020/2021

Prepared by:

Mariana Ramos | 41078

Advisor:

Luís Mota Duarte



January 2021

Private Equity Challenge

Agenda

Table of Contents

Company Overview | Information on SEM's Business Segments

SEM thrives with an adaptive business model that attracts many but different needs' patients

Business Segments

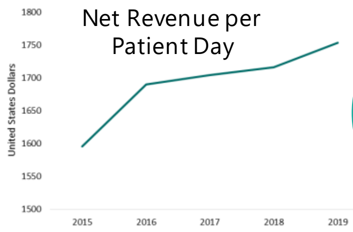
Critical Illness Recovery Hospitals	Rehabilitation Hospitals	Outpatient Rehabilitation Clinics	Occupational Health Centers
1st Admission into one of CIRHs, which ensures patient's needs are met 2nd Full assessment of the patient by specialized health care professionals 3rd Ongoing care and recovery supported by daily physician rounds	1st Referral to one of RHs, followed by assessment of care needed 2nd Care team evaluation to create a custom rehabilitative plan 3rd Treatment supported by healthcare workers to maximize independence	1st Initial evaluation by therapist who proposes an individual treatment plan 2nd Regularly scheduled appointments with a clinical member 3rd Treatment supported by healthcare workers to maximize independence	Concentra offers occupational health services to employers and respective workforce, at the workplace or at a clinic, to maintain its health and safeguard, while reducing the overall cost of health care for employers
34% of Total Revenues & 101 Locations	*12% of Total Revenues & 29 Locations*	*19% of Total Revenues & 1740 Locations*	*30% of Total Revenues & 521 Locations*
68% Occupancy Rate	76% Occupancy Rate	8,719,282 Visits	12,068,865 Visits

Target Market

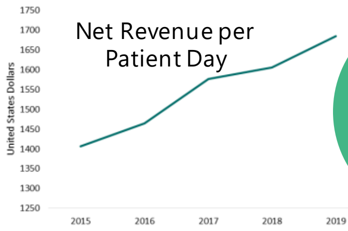
Patients recovering from critical and chronic illnesses and with complex medical needs	Patients that require intensive physical rehabilitation care to rebuild function	Patients that require physical, occupational and speech rehabilitation	Patients requiring occupational medicine/therapy consumer health services, focused on the health of America's workforce

Attracting clients through 3 channels: word of mouth (based on SEM's reputation), doctors' referral and private and public insurance programs agreements

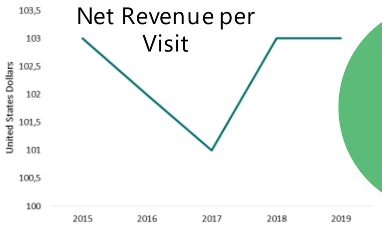
Pricing dynamics



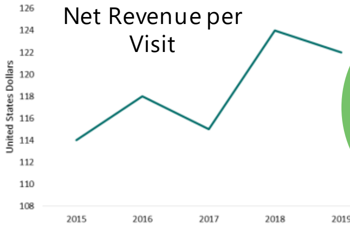
CAGR 2.37% ('15-'19)



CAGR 4.63% ('15-'19)



CAGR 0.00% ('15-'19)



CAGR 1.71% ('15-'19)

SEM's competitive position is affected by its ability of negotiating contracts with payors and, therefore, its prices can vary and rely on such agreements. The nature of the firm's industry and a highly fragmented market lead to competition between healthcare providers, giving payors significant influence and negotiating power. However, Select Medical's size and national presence, allow for strong bargaining power as well.

Source: Select Medical's Annual Report 2019 and website, Bloomberg

Historical Financial Analysis | Income Statement

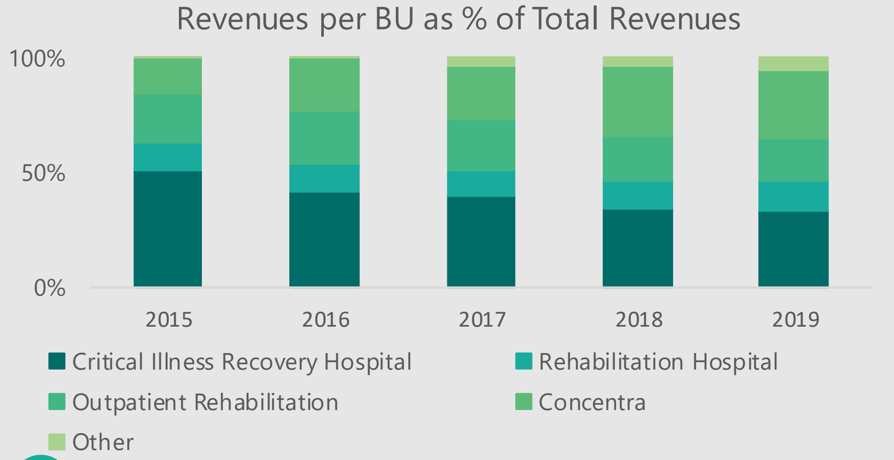
Acquisitions have been contributing and improving operational performance at Select Medical

Income Statement in $M		2015	2016	2017	2018	2019
Critical Illness Recovery Hospital		1 903	1 757	1 725	1 754	1 837
Rehabilitation Hospitals		444	498	509	584	671
Outpatient Rehabilitation Clinics		810	979	961	996	1 046
Concentra Occupational Health Centers		585	982	1 013	1 558	1 629
Other		1	1	157	190	272
Total Revenues	A	3 743	4 217	4 365	5 081	5 454
growth %			*13%*	*4%*	*16%*	*7%*
Organic Revenues	B	3 159	4 217	4 365	4 592	5 454
Inorganic Revenues		584			489	
Cost of Services	C	3 268	3 665	3 735	4 341	4 641
Gross Profit		**474**	**552**	**630**	**740**	**813**
Gross Margin %	D	*13%*	*13%*	*14%*	*15%*	*15%*
G&A		95	107	114	121	128
D&A		105	145	160	202	213
Reported EBITDA	E	**380**	**445**	**516**	**619**	**684**
EBITDA Margin %		*10%*	*11%*	*12%*	*12%*	*13%*
Net Income		**136**	**125**	**221**	**177**	**201**
Profit Margin %		*4%*	*3%*	*5%*	*3%*	*4%*

C
- COS are relevant since SEM operates in a **people intensive industry**.
- In 2015, around **half of the increase in COS** resulted from the **addition of Concentra**, which operated with a higher relative COS percentage to revenues than Select. The remaining increase was due to **training** initiatives, which continued throughout the years, and higher staff turnover.
- In 2018, the **increase** resulted from the **acquisition of U.S. HealthWorks** (facility rent expense).

D
- SEM's **gross margin** has been **slightly increasing** throughout the years, due to **increasing revenues**. However, **COS have been increasing as well** but with a lower CAGR.

COMMENTS



A
- SEM's **revenues** grew at a **CAGR of 9.87%.**
- Major source of revenue is **Critical Illness**, however its weight on total revenues has been decreasing.
- Regarding payor source, most **revenues** come from **Commercial Insurance** (32%), followed by **Medicare** (26%) and **Workers' Compensation** (21%).

B
- **Inorganic revenues**: 16% and 10% of revenues are attributed to acquisitions in 2016 (**Concentra**) and 2018 (**U.S. HealthWorks**), respectively.

E
- The **increase** from 2015 to 2016, is due to **Concentra** and, from 2016 to 2017, it is due to **Physiotherapy.**
- **Concentra and Critical Illness** contribute the most to Select Medical's **EBITDA**.

Source: Select Medical's Annual Reports

Note: Please check **Appendix II.1.** for a more detailed analysis of the Income Statement.

Note: in 2019, for comparison purposes, we had to undue the adoption of a **new accounting standard on Leases** (ASC Topic 842).

Historical Financial Analysis | Statement of Cash Flows

Select Medical's Free Cash Flow has a CAGR of 191% from 2016 to 2019

Cash Flow Statement in $M		2015	2016	2017	2018	2019
Net Income		136	125	221	177	201
+ Non-Cash Items		153	203	114	233	257
+ Changes in Net Working Capital		-81	18	-97	84	-13
Cash Flow from Operating Activities	A	**208**	**346**	**238**	**494**	**445**
As % of total Revenues		6%	8%	5%	10%	8%
+ Purchases of PP&E	B	-183	-162	-233	-167	-157
As % of total Revenues		5%	4%	5%	3%	3%
+ Net Payments for Acquisitions		-1 063	-396	40	-530	-160
+ Net Payments for Marketable Securities		33	4	0	0	0
Cash Flow from Investing Activities	C	**-1 213**	**-554**	**-193**	**-697**	**-317**
As % of total Revenues		32%	13%	4%	14%	6%
+ Debt-related Cash Flows		830	284	-8	574	98
+ Equity-related Cash Flows		184	8	-13	-318	-66
Cash Flow from Financing Activities		**1014**	**292**	**-22**	**256**	**32**
As % of total Revenues		27%	7%	0%	5%	1%

Free Cash Flow In $M		2015	2016	2017	2018	2019
EBITDA		**380**	**445**	**516**	**619**	**684**
growth %			17%	16%	20%	11%
- Income Taxes	D	72	55	-18	59	64
growth %			-23%	-133%	-422%	9%
- △NWC		-113	171	124	-28	219
growth %			100%	-27%	-123%	-882%
- CAPEX	B	418	157	163	239	201
growth %			*-62%*	*4%*	*47%*	*-16%*
FCF (cash generation)	E	3	61	247	349	200
growth %			*2108%*	*303%*	*42%*	*-43%*

COMMENTS

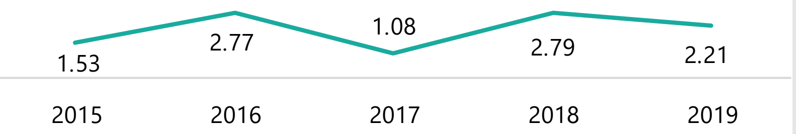
A
- **Operating CF** has been **fluctuating** since 2015.
- Partially attributed to **oscillations** in **A/R** and in **deferred income taxes**.

B
- As a **capital-intensive industry** such as healthcare, Select Medical faces **slight changes** when it comes to **Purchases of PP&E** since 2015.

C
- **Downward trend** in **Investing CF.**
- **Significant increase** in 2015 and 2018 due to acquisitions of Concentra and U.S. HealthWorks.

D
- In **2017**, Income Taxes were negative due to effects resulting from a reform considering **federal legislation** on deferred tax liability.

E
- SEM's **Free Cash Flow** has been **increasing** since 2015, except for 2019.
- Mostly due to **oscillations** in captions that determine **NWC and its investment.**
- The **Cash Conversion Ratio** has evolved in the following manner:



Note: Please check **Appendix II.3.** for a more detailed analysis of the Statement of Cash Flows.

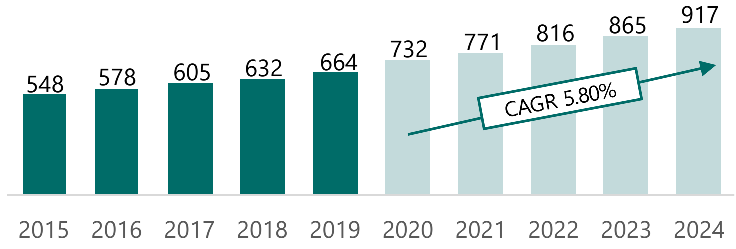
Source: Select Medical's Annual Reports

Market Overview | American Healthcare Industry - Segments

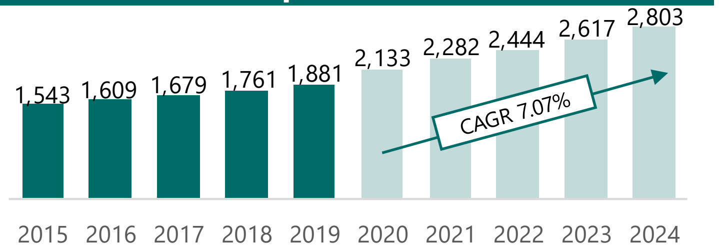
Inpatient and Outpatient Care are the most relevant segments in the healthcare industry

Market Value ($B)

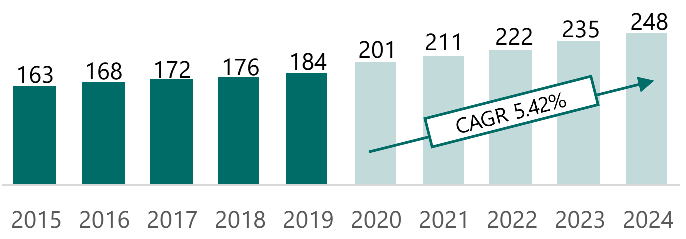
Inpatient Care



Outpatient Care



Long-Term Care



Key facts

Inpatient Care

- U.S. inpatient care market is expected to grow at **5.8% CAGR until 2024,** accounting for **17.4%** of the total healthcare industry in 2019.
- This segment's growth is restricted by the **cost of U.S. healthcare**.

Outpatient Care

- U.S. outpatient care is expected to grow at **7.07% CAGR until 2024**, accounting for 50.8% of the total healthcare industry in 2024.
- The outpatient care segment is **less capital intensive** when compared to others.

Long-Term Care

- U.S. long term care is expected to grow at **5.42% CAGR until 2024**, accounting only 4.8% of the total industry in 2019.
- However, it **accelerated more** than any other segment in 2019, reflecting aging population.

Key players

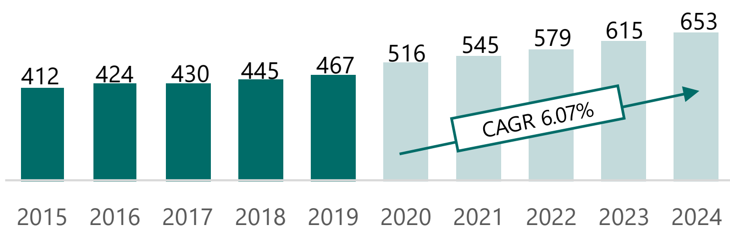
Encompass Health, Kindred Healthcare, CHS Community Health Systems

Upstream Rehabilitation, USPh U.S. Physical Therapy, Inc., ATI Physical Therapy, Athletico Physical Therapy

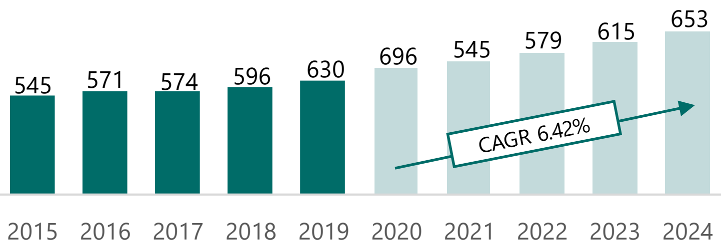
Genesis, Brookdale Senior Living, Atria Senior Living

Market Value ($B)

Medical Goods



Collective Services and Capital Formation



Key facts

Medical Goods

- U.S. medical goods market is expected to grow at **6.07% CAGR until 2024**.
- This segment's weight in the healthcare industry is expected to **decrease** throughout the years, being around **11.9% in 2024**.

Collective Services and Capital Formation

- This segment is expected to grow at **6.42% CAGR until 2024**.
- This segment's weight in total healthcare expenditures will **slightly decrease** and stabilize at **16.2% in 2024**.

Main takeaways:

Outpatient care is the segment expected to **grow at a faster pace**. Also, it is expected that this segment's weight increases until 2024.

Inpatient care's weight on the entire healthcare industry has increased however, from 2018 until 2024, it is expected to **decline**.

The **long-term care and medical goods segments** have been **constantly decreasing its weight on total healthcare expenditures.**

Source: Marketline "Healthcare providers in the United States", Select Medical's reports

Investment Thesis

Select Medical's background and experience allows for superior competitive position

Deal Rationale

1 Leading market position

- The success of Select Medical is based on several **competitive strengths**, including the **leading position** in each business segments.
- The segments have all been growing in the past years and present prospects of **profitable growth** mainly due to the company's **strong reputation and national presence**.

2 Good financial performance

- The company presents a track record of **increasing revenues and EBITDA margin.**
- **Healthy FCF generation which has been positive and overall increasing** throughout the years and is expected to continue to deliver such values.
- The company has a **leverageable balance sheet** due to a strong asset base (growing at a CAGR of 9.37%) and a low and decreasing CAPEX as % of sales.

3 Skilled management team

- Select Medical Holdings is backed-up by a **strong management team with** years of experience in this industry as well as in the company.
- Most executives have been on the firm for **several years** and have proven their ability on leading the company.

4 Acquisitions experience

- The company portraits **willingness to expand** and acquire new companies in the future, **in order to consolidate its position**.
- Select Medical has proven its **ability** regarding the **selection and target integration of the acquired firms**.

Value Creation Strategies

Portfolio Expansion

- Select Medical Holdings has the ability to strengthen its leadership position by **adapting** to the new context brought by the **pandemic**.
- Namely, by **diversifying its services portfolio** and offer better and competitive solutions.
- Select Medical can explore new opportunities in the **telemedicine and behavioral health industries** concerning outpatient and occupational therapy, offering alternatives to patients who are in need and expand its services' portfolio, creating a new stream of revenue for the firm.

Bolt-on Acquisitions

- Due to the **high level of fragmentation** of the healthcare industry, SEM can **acquire and incorporate strategic players** in the market, improving its competitive positioning and assure growth.
- The **company has a strong track record** and **experience** in successfully completing and integrating acquisitions.

Operational Turnaround

- Select Medical can improve its **operations** management.
- According to the company's annual report, operating performance can be improved at the **acquisitions level**, for example, by imposing **best management practices** and by **realizing efficiencies**, as the activities and management would be centralized.
- Furthermore, the firm **is well positioned** to improve its **free cash flow generation and management**.

Source: Select Medical's Annual Reports

Value Creation Strategies | Portfolio Expansion

Through an expansion of the services SEM provides, it can strengthen and improve its leading position

STATUS QUO

Within the Outpatient Rehabilitation and Concentra segments, the following services are provided:

Physical Therapy*	Hand / Occupational Therapy*	Pediatric Therapy*
Work Health*/**	Low Back Rehabilitation*	Sports Medicine*
Aquatic Therapy	Cancer Rehabilitation*	Vestibular Rehabilitation*
Women's Health*	Orthopedic Rehabilitation	Prosthetics and Orthotics

*services that may be adapted to telemedicine **Concentra segment

In 42 states and District of Columbia & counting…

PORTFOLIO EXPANSION RATIONALE

Select Medical has a Market **leading position** which can be leveraged and consolidated by **expanding** and **diversifying its services' portfolio**

Select Medical should implement the following services in its Outpatient/Concentra segments:

Telemedicine | **Behavioral Health**

With these two segments within the services offering, Select Medical will **consolidate its clients base** and **attract new clients**, which will lead to a rapid **increase in revenues** and to a **differentiating advantage** among its peers.

OBJECTIVES

1. **Growth of revenues** from existing clients within the new services.
2. **Complete and diversify services panoply** that are offered by Select Medical.
3. **Attract new clients**, creating new revenue streams.
4. **Improvement of competitive advantages** such as the leadership in Outpatient/Concentra segment.

EXECUTION

Telemedicine

Acquire adequate software (i.e. app) to be able to:
- conduct **online consultations.**
- transfer of **health history** and/or **medical records**[1.]
- **monitor patients' health** and medical data[1.]
- **provide healthcare services** and **public health notifications.**

Behavioral Health

In states like Arizona, Colorado, North and South Carolina, SEM will invest:
- In **behavioral healthcare professionals.**
- In **equipment** for specific segments of behavioral health (i.e. autism).

1. - over secure electronic means

EXPECTED RESULTS

Telemedicine:
- Higher revenue growth.
- Broader clients base.
- Lower operating costs.
- Consolidation of Select Medical as market leader in outpatient and occupational segments.

Behavioral Health:
- Higher revenue growth.
- Broader clients base.
- New revenue stream that complements services already provided.

Note: Please check **Appendix III.1. and III.2.** for detailed analysis of Telemedicine and Behavioral Health strategies.

Source: Select Medical's Annual Reports and website

Value Creation Strategies | Bolt-on Acquisitions

Bolt-on acquisitions strategy allows for value creation and market consolidation

STATUS QUO

SEM has **successfully** been **acquiring** attractive targets to **consolidate** its **leadership position** as one of the largest health care providers in the segments that it operates, based on the number of facilities and revenues.

- The company's **selective M&A policy** aligned with well-defined **acquisition criteria** have been proved successful so far.
- The **highly fragmented market** of Outpatient and Concentra offer opportunities for **consolidation** and strengthening of Select Medical's competitive position.
- The Outpatient segment is **growing** and has been little affected by economic downturns.
- The more fragmented the market is, the lower the negotiating leverage of healthcare providers. Therefore, consolidation helps SEM become larger with fewer competitors, which **increases its pricing power over private insurance companies.**

RATIONALE

Strengthen the competitive position and **expand** the **portfolio**, increase **revenues**, reduce operational and fixed costs (economies of scale), and acquire a stronger ability to navigate the uncertainty surrounding the future of healthcare.

Competitive position & Portfolio expansion

- Market divisions across the U.S. provide opportunities for M&A in order to **increase SEM's market share.**
- Acquiring companies with expertise in other health care segments allows **rapid entrance** in **new profitable segments**.

Revenues growth

- Integrating new companies **improves** organic **sales growth** in the following years after acquisition.

Economies of scale

- SEM's fixed costs are large and **horizontal expansion** can spread those costs across a greater volume of patients.

OBJECTIVES

1 Value creation

- Acquire companies with strong cash flows and **revenue growth** in order to improve Select Medical's revenues through **cross-selling** and **enlargement of the customer base**.
- Allow Select Medical to **continue to provide care** for its patients after being discharged from critical care.
- **Improve operating margins** through cost **synergies** obtained with the acquisitions.

2 Consolidate market position

- **Obtain significant position** in the **Outpatient** segment, which is growing faster than any other segment.
- **Expand the portfolio** of segments in which Select Medical is present.
- Become an even **more significant national player** in the healthcare sector.

EXECUTION

- Acquire **two pre-selected targets**, which are located across the **U.S.**.
- Formulating and executing an **integration plan** for the acquired companies to **benefit from cost synergies and larger client base**.

EXPECTED RESULTS

- **Additional inorganic EBITDA** between 2020 and 2025 of more than $300M.
- **Expansion of portfolio** and **cost related synergies**.

Source: Company's annual reports and website and Marketline "Healthcare providers in the United States"

Value Creation Strategies | Operational Improvement

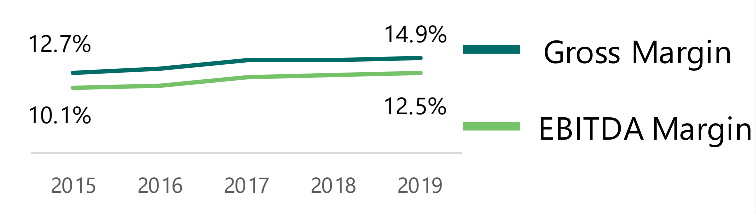
Enhanced profitability through the implementation of an ERP system and use of innovative technologies

STATUS QUO

Until 2019….

SEM' management team has been **centralizing** key administrative services in order to improve operating efficiency and **control costs**.

Results: 2015-2019



Future plans:

- **Cease** operations in **less efficient facilities** and in states with lower reimbursement rates.
- Cost cutting and efficiency gains through the **implementation of better operating systems**.
- Use of **innovative technologies** in the facilities.

RATIONALE

Take an insightful look into the company's operating performance and take advantage of technology to improve SEM's performance.

Cease facilities

- Decrease the number of **less efficient clinics** in states with **lower reimbursement rates** (Florida and Texas which also have a higher percentage of uninsured population) and also due to the **introduction of telemedicine**.

Implementation of ERP system

- Through **ERP**, Select Medical will have a more **detailed** and **wholesome knowledge** of the company's financial and operating performance.

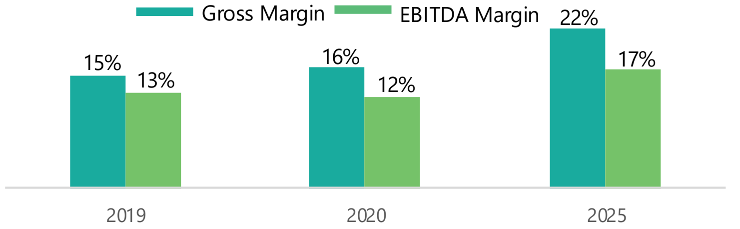
Innovative technologies

- **Provide first-class service** and care to assist and contribute to patients' recovery.

OBJECTIVES

1 **Increase operating margins**

Drive growth of operating margins towards peers' values through efficiency enhancements measures.



2 **Increase revenues through new patients**

- The **ERP** implementation allows for **better management** and providing better patient care, increasing quality and attracting patients.
- **Innovative technologies** contribute to a **faster rehabilitation** and patients' engagement, increasing the quality of the service provided.

EXECUTION

- Assess states with higher number of outpatient clinics and lower reimbursement rates to **cease less efficient facilities.**
- **Implement ERP** in current and acquired facilities, **increasing productivity and efficiency** and providing management with **better tools** to assess operating performance.
- Implement **advanced robotics** in inpatient rehabilitation clinics.

EXPECTED RESULTS

- **Profitability margins** closer to peers', becoming **more competitive**.
- **Maximized efficiency** throughout facilities and **faster incorporation** of acquired companies or facilities.
- **Improvement of service quality** through better management services which allow physicians to provide better care.
- **Development** of provided care through the use of **innovative technologies.**

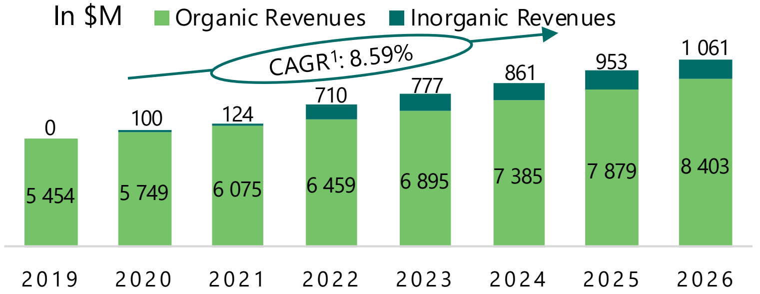
Note: Please check **Appendix III.4** for detailed analysis of Operational Improvement.

Source: Select Medical's Annual Reports and website

Business Plan | Overview of Main Drivers

With strategic acquisitions and costs improvement, SEM is set for a high growth path in the next 6 years

Select Medical's Growth



1 Organic Growth

Main drivers of SEM's organic growth:

- **Growth** of SEM's on-facility services, and telemedicine services especially in **Outpatient** and **Concentra** segments, almost in line with each segment's market growth.
- The most relevant segments within the organic revenues are **Concentra** Occupational Health Centers and **Critical Illness** Recovery Hospital.

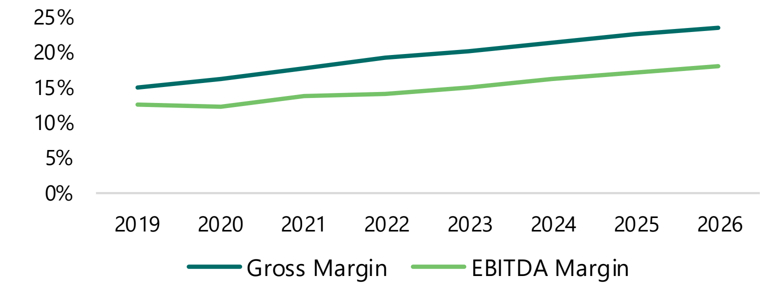
2 Inorganic Growth

Select Medical will be acquiring two other small strategic companies. These will allow to:

- Add **revenues of $953M** at exit.
- Enter the **respiratory services** and **post-acute care** segments, which both yield high revenues.
- **Increase** SEM's **geographical presence**.

[1]- From 2020 to 2025

Costs



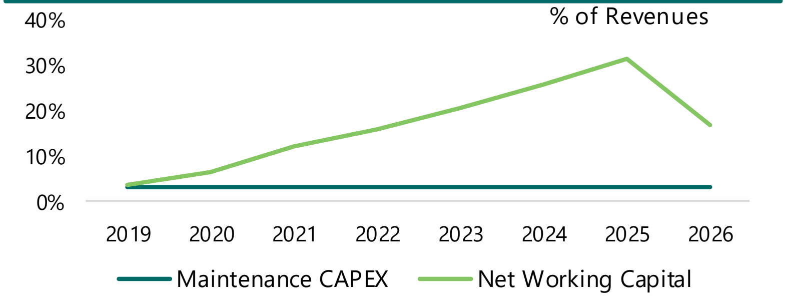
1 Costs of Services

- COS are expected to grow at a CAGR[1] of 6.90%.
- SEM will benefit from synergies due to acquisitions (we expect **supplies expense to decelerate** its growth by 1.25% per year from one year after the first acquisition onwards), and the **operational turnaround** will allow it to close the less profitable facilities.
- However, portfolio **expansion strategy** will not allow COS to slow down as much since **more healthcare professionals** will be employed.

2 Operating Expenses

G&A: It is expected to increase in 2020 due to investment in **ERP system**. However, from **2021 to 2025**, it will decelerate its growth fulfilling **cost-efficiencies**.
D&A: its YoY growth is fairly stable however, in 2020 and 2022 it increases due to the **acquisitions** of Viemed (6%) and Diversicare (11%), accordingly.

Investments



1 Maintenance CAPEX

Even though it remains constant at **3% of Revenues**, Maintenance CAPEX faces an increase of $113M from 2019 to 2025 due to strategies and equipment[2] to achieve target revenues.

[2]- Includes Equipment of SEM, Viemed and Diversicare

2 Expansion CAPEX

The Expansion CAPEX is stable as percentage of total revenues. However, in 2020 and 2022 it will significantly increase due to **acquisitions** that will contribute with **$88M** in **EBITDA at exit**, in 2025. Acquisitions will be financed using 50% of CAPEX facility and 50% of cash.

3 Net Working Capital

Net Working Capital is constantly **increasing** during the entire investment period due to a general **increase in all current assets**, especially cash and cash equivalents.

Exit & Returns | Capital Structure

Total leverage of 5.5x EBITDA and an equity contribution of 9.8x EBITDA for SEM's acquisition

Select MEDICAL

	Amount	%	xEBITDA	Pricing
Term Loan A	-	-	-	L + 375 bps
Term Loan B	$2 053	19.7%	3.0x	L + 400 bps
Term Loan C	$1 027	9.8%	1.5x	
Mezzanine	$684	6.6%	1.0x	
PIK Element				600 bps
Cash Element				L + 675 bps
Institutional Strip				
PE Fund				
Fixed Return Inst.	$6 435	61.6%	9.4x	1250 bps
Institutional Ords	$189	1.8%	0.3x	
Total	**$6 624**	**63.4%**	**9.7x**	
Management				
Fixed Return Inst.	$46	0.4%	0.1x	1250 bps
Institutional Ords	$1	0.0%	0.0x	
Total	**$10**	**0.1%**	**0.0x**	
Sweet Equity	**$57**	**0.5%**	**0.1x**	
Total Sources	**$10 446**	**100%**	**15.3x**	

	Amount	%
Equity Purchase	$7 025	67.3%
Repay Existing Debt	$3 109	29.8%
Financing Fees	$210	2.0%
Other Fees and Expenses	$101	1.0%
Total Uses	**$10 446**	**100%**

Instrument	Structure 1	Structure 2	Structure 3
Senior Tranche A	-	$856	-
Senior Tranche B	$2 053	$1 027	$1 711
Senior Tranche C	$1 027	$1 027	$1 027
Mezzanine	$684	$856	$684
Equity Contribution	$6 681	$6 681	$7 024
Leverage	5.5x	5.5x	5.0x
MM at Exit	3.03x	3.02x	2.95x

- Three potential capital structures were analyzed so as to compare returns at exit Capital **structure 1** is the **preferred** as Capital Structure 2 delivers a slightly **lower money multiple** at exit and the leverage multiple is the same.
- Capital **Structure 3** requires the lowest amount of debt, and yields **the lowest MM.**

Comments

Uses of Funds

- **Total uses** of funds, totalling **$10,446m**, are destined to pay for **EV of $10,134m**and the remaining amount is for **financing fees** and **other fees and expenses** related to the transaction.
- **Enterprise Value** is based on a **EV/EBITDA multiple of 14.81x** estimated in the valuation section.

Sources of Funds

- Total uses of funds are sourced from an **equity contribution** of **9.8x EBITDA** ($6,681m) and **leverage** of **5.5x EBITDA** ($3 765m).
- For the debt portion of the sources, there are **three tranches of senior debt** and **mezzanine debt.** All of the mentioned are contracted in U.S. dollars and non-amortizing for tranches B and C and mezzanine.
- The equity contribution is composed of a **fixed return instrument of $6,481m** and **ordinary equity of $190m.**
- Top management will hold **$10m** worth of shares (**sweet equity**), which is twice their combined annual compensation, and also **$45m of FRI and $1m of ordinary equity**, in order to align interests.

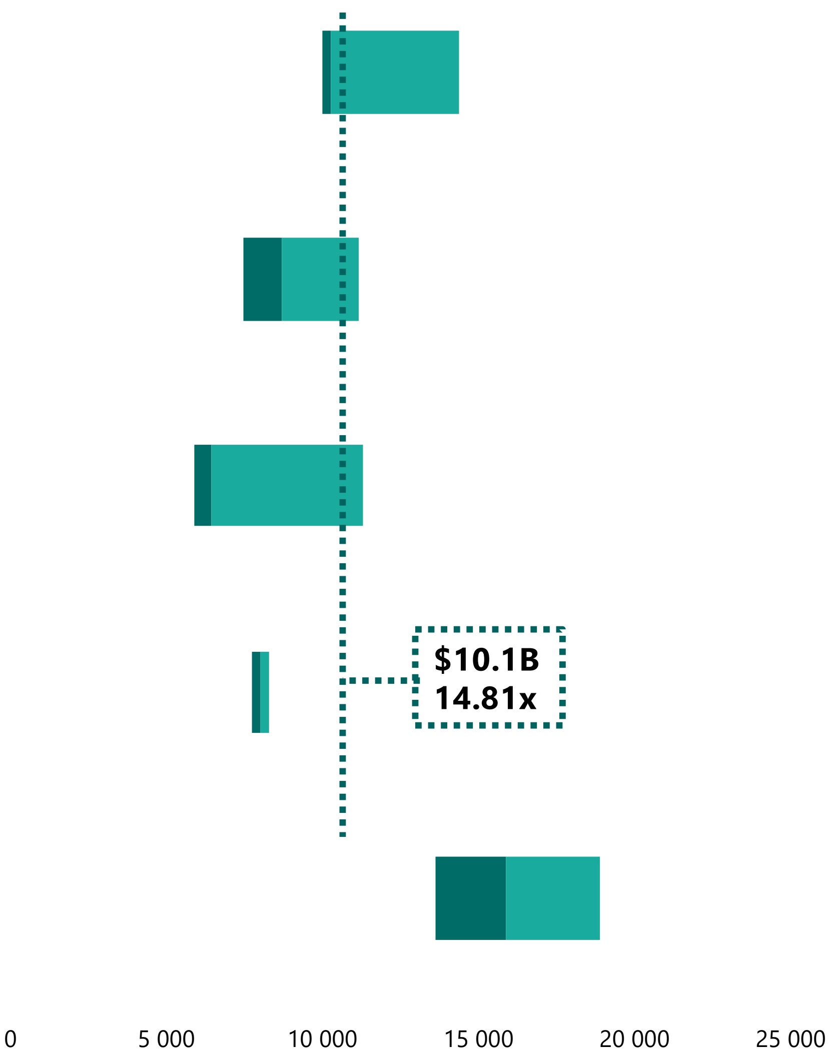
Other

- A **CAPEX Facility** of **$236m** will be used to partially finance the **planned acquisitions** throughout the investment period.

Note: Please check **Appendix IV.4, IV.5, IV.6** for detailed capital structures in different scenarios and **IV.7** for detailed financing structures.

Exit & Returns | Entry Valuation

Through the football field analysis with several methodologies, a 14.81x EV/EBITDA multiple was achieved

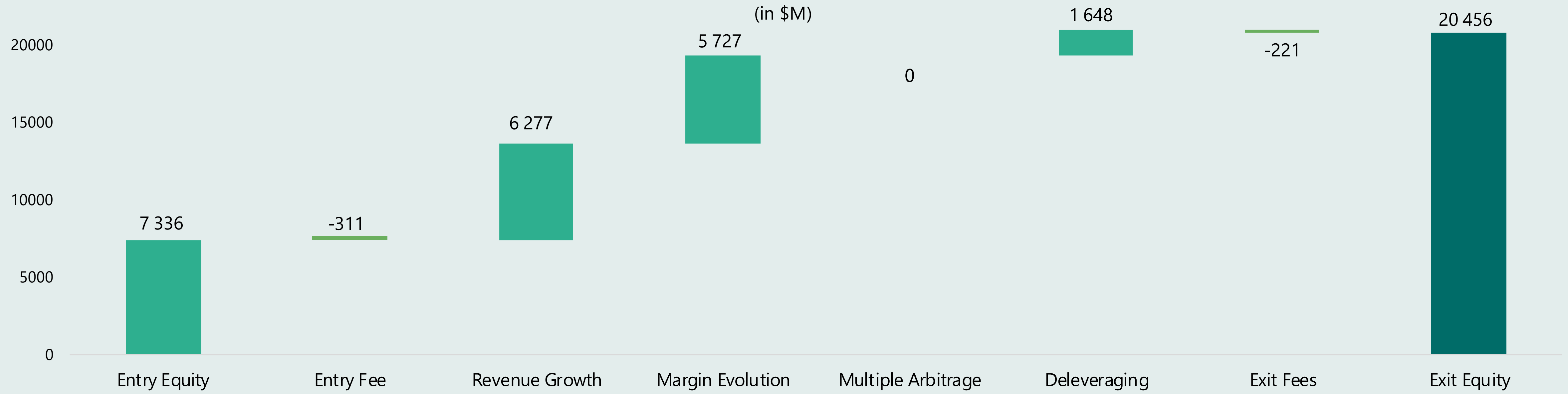
Methodology	Enterprise Value - Football Field	EV/EBITDA Multiple	Comments
Trading Comparables		**14.97x** 14.63x – 20.99x	• *Sources: Bloomberg and Reuters.* • The minimum value for the multiple was **11.39x** whilst the maximum was **27.08x**, suggesting a big gap between valuations.
5-year Through-the-Cycle Multiples		**12.70x** 10.96x – 16.32x	• Overall, multiples of comparable companies **have been increasing** throughout the years however, 2018, seemed to be the year with the highest multiples. • The **minimum** multiple was **8.49x** (2016) and the **maximum** was **27.54x** (2018).
Precedent Transactions		**9.39x** 8.62x – 16.50x	• Precedent transactions were selected from Reuters industry sector. • As seen in the previous methodology, there is also a **large interval** between minimum and maximum multiples, **5.70x to 24.99x**.
Share Price Premium		**11.71x** 11.28x – 12.07x	• The share prices 1 day, 1 week and also 1 month prior to acquisition (of the same companies as in precedent transactions) were analyzed. • The **premium was applied to SEM's share price** prior to acquisition.
Discounted Cash Flow		**24.25x** 19.94x – 27.58x	• For the DCF, **WACC** was estimated based on the company's **latest bond issues** and recent information. The **terminal growth rate** ranged from **1.0% to 1.5%.** • This method yielded the **highest minimum and maximum EV/EBITDA** multiples.

Note: Please check **Appendix IV.1, IV.2 and IV.3** for detailed methodology analysis.

Exit & Returns | Returns Breakdown

Select Medical's strong margin evolution and revenue growth will drive a Money Multiple of 3.03x

RETURNS BREAKDOWN



Revenue Growth

- The **Revenue Growth** is the most important return driver in the **Investment Case**, contributing with **0.86x** in terms of multiples.
- This is obtained due to the **business strategy** of implementing **new revenue streams** and of accomplishing **new acquisitions**.

Margin Evolution

- The **Margin Evolution** is the second most important return driver in the **Investment Case**, contributing with **0.82x** in terms of multiples.
- This is obtained due to the high **revenue growth** throughout the investment period and due to the **efficiency gains** predicted in the business plan.

Deleveraging

- The **Deleveraging** is the third most important return driver in the **Investment Case**, contributing with **0.23x** in terms of multiples.
- This is obtained mostly due to the **demanding and well-established debt repayment schedule** but also due to the **great performance** that is expected from Select Medical.

Multiple Arbitrage

- The **Multiple Arbitrage** is expected to have a **null impact** on the returns as the **U.S. economy** will face **many challenges** in the **near future**.

Entry & Exit Fees

- The Entry & Exit Fees will play a **negligent role** in the returns. However, must **be highlighted**.

Exit Strategy | Exit Options

Strategic sale is the most favorable exit option for the Private Equity Fund

	Strategic Sale	Secondary Sale	Initial Public Offering	Sale in parts
Advantages	• Healthcare is **highly fragmented** in the U.S. and there are significant **consolidation** efforts in the market, leading to **several interested buyers** and a **strong competition**. • There are larger healthcare companies with resources to acquire SEM and gain synergies.	• Despite the crisis created by the ongoing pandemic, there has been **M&A activity in the healthcare industry among PE funds**. • Private Equity funds had around **$2 trillion of dry-powder** as of July 2020.	• An **IPO** would allow Select Medical to have access to a **larger market** when comparing with the remaining exit options. • Considering the size of the company, it is a **good potential candidate** for this exit strategy.	• Potential buyers might only be **interested in some segments** of the company. • Some business segments are growing at a **faster rate** than others.
Disadvantages	• Depending on the situation, the **transaction** might be a **slow process.**	• There is the possibility that investors are in **both the buyers' and seller's funds** thus, not getting liquidity and end up investing in the same company. • Other PE firms may believe the efficiencies have been explored to their maximum.	• This strategy **relies on the current capital market conditions** and is generally **more expensive**. • With the current COVID-19 crisis, there is still **uncertainty** regarding forecasts and prospects for the markets in 2024, **increasing risk**.	• This exit strategy leads to the **loss of synergies** created throughout the investment period. • Might lead to **longer process** since it would require several buyers.
Potential Parties	Encompass Health HCA Healthcare UHS Tenet Health	Silver Oak Services Partners Apollo KKR ElmCreek Partners Altamont Capital Partners	NYSE	Encompass Health UHS Tenet Health

Source: PwC

Exit Strategy | Key Due Diligence Areas

Important areas such as Commercial and Financial must be further explored for a successful transaction

	Area	Key focus aspects	Potential issues	Relevance
Commercial	**Market analysis**	• How dependent is the market growth from macroeconomic conditions • Examination of genuine strength of significant patterns during the next 5 years for each segment where SEM operates	• Economic crisis materially impacting the forecasts, affecting revenues • Overestimation of positive outlook in target markets • Future market trends that SEM is not capable of supplying	
Commercial	**Patients**	• Identify the type of patients that most utilize SEM's services • Evaluate if there are patients that were lost in the recent years and why it happened	• High dependency on some types of patients • Considerable number of unsatisfied patients	
Commercial	**M&A targets**	• Thoroughly analyze the acquisition targets (specially margins, growth prospects and synergies)	• Inability to follow the acquisition strategy due to difficult integration and/or unrealistic synergies	
Commercial	**Competitive position**	• Detailed analysis of competitors per service and location • Compare SEM's competitive advantages with the competitors'	• Inability to outperform the market • Competitors being able to replicate SEM's business model and service quality	
Operat.	**ERP system**	• Evaluation of the efficiencies and cost reductions obtained with the implementation of ERP system	• ERP system implementation takes a long time and generates more costs than benefits on the ST.	
Operat.	**Supply chain**	• Explore in detail and question some of SEM's current suppliers • Assess post-integration synergies after targeted acquisitions	• High dependence on a few suppliers can difficult the operational turnaround strategy	
Financial	**Financials**	• Perform an in-depth financial statement analysis (revenue and cash-flow generation, debt valuation assumptions, evaluate Goodwill and PP&E to assess any necessary impairments)	• Accounting frauds (overstating revenues, unrecorded expenses, misstatement of assets and liabilities)	
Financial	**Fixed asset optimization**	• Evaluate facilities' utilization rates & capacity to foster growth • Compare the leasing of facilities strategy with their ownership	• It is difficult to increase the nr. of services offered at current facilities if they are at maximum capacity	
Legal	**ESG, insurance, and tax**	• Verify compliance with environmental policies, assess insurance coverage, and any tax-related case pending with tax authorities	• Lack of proactive ESG actions, inappropriate insurance coverage	
Legal	**Pension plans**	• Appraisal of pending pension plan payments	• Large expected losses due to future settlements	

Select Medical Holdings

Investment Committee Paper

Academic Year 2020/2021

Exit & Returns

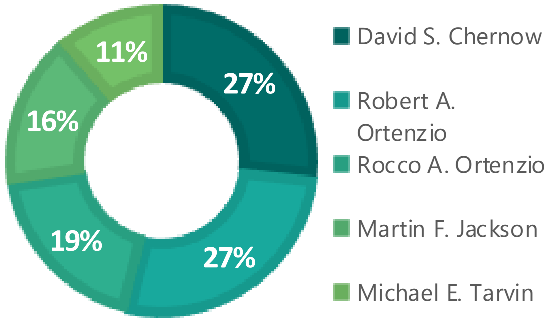
Exit & Returns | Management Package

By committing 2x its compensation, SEM's management team will have a return of 10.3x on the exit year

MANAGEMENT TEAM'S COMPENSATION PACKAGE

Management Investment Structure

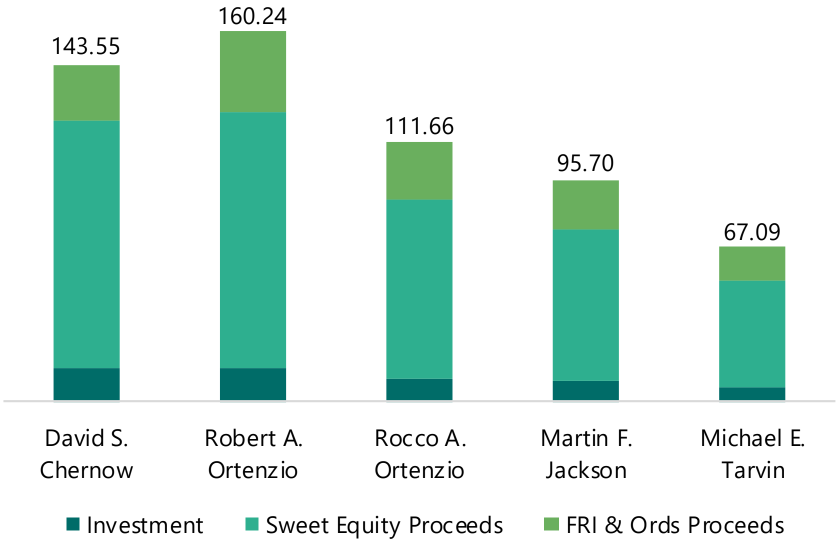
By committing **2x the sum of its salary and compensation** into **Sweet Equity** and into **Fixed Return Instrument** and **Ordinary Shares**, SEM's Management Team will participate in the capital structure so that they keep committed and with both interests aligned.



Sweet Equity Investment ($M)	
David S. Chernow	2.68
Robert A. Ortenzio	2.70
Rocco A. Ortenzio	1.88
Martin F. Jackson	1.61
Michael E. Tarvin	1.13
Total	10.0

FRI & Ords Investment ($M)	
David S. Chernow	12.69
Robert A. Ortenzio	12.79
Rocco A. Ortenzio	8.91
Martin F. Jackson	7.64
Michael E. Tarvin	5.36
Total	47.39

MANAGEMENT TEAM'S RETURNS



(in $M)	2020	2021	2022	2023	2024	2025	2026
Sweet Equity							
Exit Proceeds	21.33	95.12	173.14	247.61	353.78	**449.92**	555.41
Initial Investment	10.0	10.0	10.0	10.0	10.0	**10.0**	10.0
Return Multiple	2.1x	9.5x	17.3x	24.8x	35.4x	**45.0x**	55.5x
FRI & Ords							
Exit Proceeds	48.92	64.63	81.64	98.97	121.49	**143.69**	168.29
Initial Investment	47.39	47.39	47.39	47.39	47.39	**47.39**	47.39
Return Multiple	1.0x	1.4x	1.7x	2.1x	2.6x	**3.0x**	3.6x
Management Team Multiple	1.2x	2.8x	4.4x	6.0x	8.3x	**10.3x**	12.6x

Exit & Returns | Returns

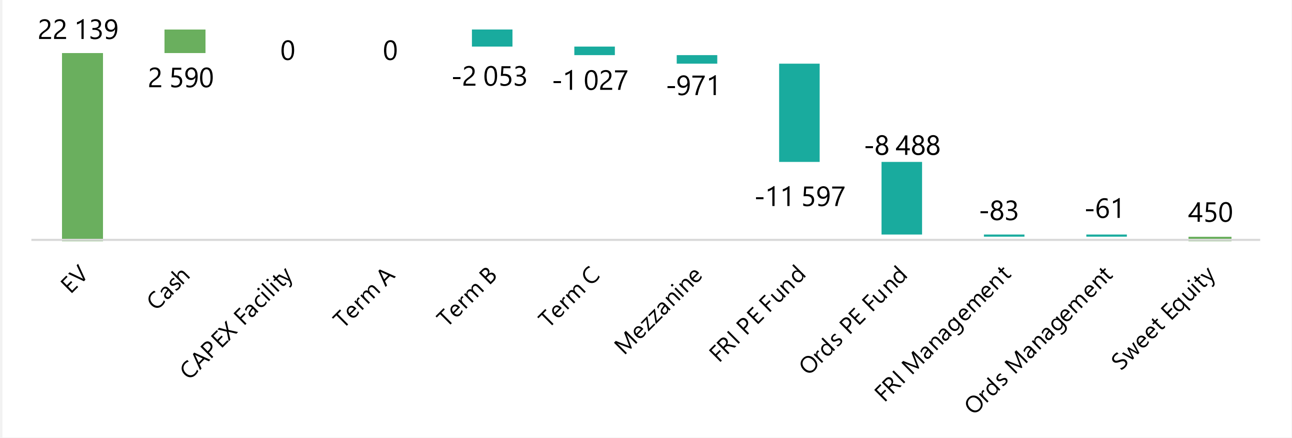
At the exit year, the LBO model projects a 3.03x MM and an IRR of 20% for the Private Equity Fund

Institutional Investor Returns

Returns (in $M)	2020F	2021F	2022F	2023F	2024F	2025F	2026F
Institutional Investor Exit Proceeds	6 837.7	9 034.1	11 410.9	13 833.8	16 982.1	**20 084.3**	23 524.0
Institutional Investor Equity	6 623.9	6 623.9	6 623.9	6 623.9	6 623.9	**6 623.9**	6 623.9
Institutional Investor Returns	1.0x	1.4x	1.7x	2.1x	2.6x	**3.0x**	3.6x
Institutional Investor IRR	3%	17%	20%	20%	21%	**20%**	20%

At the exit year, the **Private Equity Fund** receives **$20,084M**, obtaining a **MM of 3.03x** and an **IRR of 20%.**

Exit Waterfall

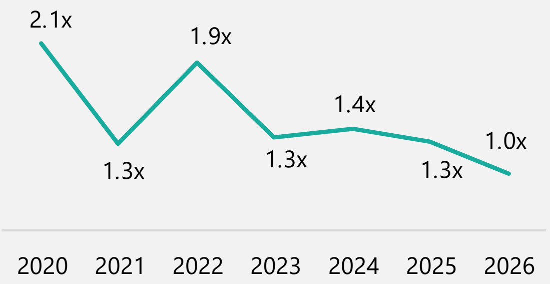


For this Business Plan, Multiple Arbitrage is assumed to have a null impact, leading to an **exit EV/EBITDA of 14.81x in 2025**. The **Equity Value** at exit is expected to be $20,678M, **meaning a 2.94x MM**.

Credit Statistics

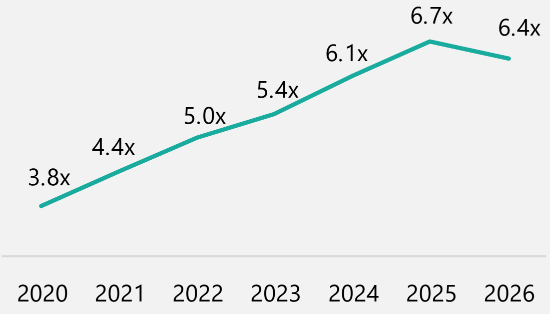
Cash Cover

- Cash Cover is **above 1.0x throughout the investment period**.
- From 2023 onwards, cash cover is lower than in previous years due to repayment of Capex Facility.



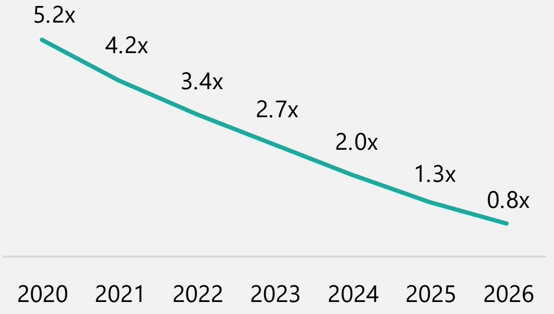
Interest Cover

- Interest Cover **is constantly above 1.0x** during the investment period and it is increasing.
- The growth of this covenant is attributed to **EBITDA growth.**



Net Debt / EBITDA

- Net/EBITDA covenant is decreasing due to both an **increase in EBITDA and a decrease in Net Debt** throughout the investment period.



Note: Please check **Appendix IV.4, IV.5 and IV.6** for detailed analysis of returns with different operating scenarios .

Exit & Returns | Sensitivity Analysis

The returns provided in the Investment Case are robust and able to originate a great return for the PE Fund

INVESTMENT CASE

Money Multiple for PE Fund

Year		2024	2025	2026
Exit Multiple	13.81x	2.38x	2.82x	3.31x
	14.31x	2.47x	2.93x	3.43x
	14.81x	2.56x	***3.03x***	3.55x
	15.31x	2.66x	3.14x	3.67x
	15.81x	2.75x	3.24x	3.79x

IRR for PE Fund

Year		2024	2025	2026
Exit Money Multiple	2.03x	19%	19%	19%
	2.53x	20%	20%	19%
	3.03x	21%	***20%***	20%
	3.53x	22%	21%	20%
	4.03x	22%	22%	21%

- In the **Investment Case**, the money multiple for the **Private Equity Fund** will be **3.03x**, which will yield a IRR of **20%**.
- For the **Management team**, the Money multiple will be **10.34x**, which will yield a IRR of **48%**.

BANK CASE

Money Multiple for PE Fund

Year		2024	2025	2026
Exit Multiple	13.81x	2.06x	2.40x	2.75x
	14.31x	2.15x	2.49x	2.85x
	14.81x	2.23x	***2.58x***	2.95x
	15.31x	2.32x	2.67x	3.06x
	15.81x	2.40x	2.77x	3.16x

IRR for PE Fund

Year		2024	2025	2026
Exit Money Multiple	2.03x	16%	16%	16%
	2.53x	17%	16%	16%
	3.03x	17%	***17%***	17%
	3.53x	18%	18%	17%
	4.03x	19%	18%	18%

- In the **Bank Case**, the money multiple for the **Private Equity Fund** will be **2.58x**, which will yield a IRR of **17%**.
- For the **Management team**, the Money multiple will be **7.21x**, which will yield a IRR of **39%**.

MANAGEMENT CASE

Money Multiple for PE Fund

Year		2024	2025	2026
Exit Multiple	13.81x	3.03x	3.65x	4.35x
	14.31x	3.14x	3.78x	4.50x
	14.81x	3.26x	***3.91x***	4.65x
	15.31x	3.37x	4.04x	4.80x
	15.81x	3.49x	4.17x	4.95x

IRR for PE Fund

Year		2024	2025	2026
Exit Money Multiple	2.03x	25%	24%	23%
	2.53x	26%	25%	24%
	3.03x	27%	***26%***	25%
	3.53x	28%	26%	25%
	4.03x	28%	27%	26%

- In the **Management Case**, the money multiple for the **Private Equity Fund** will be **3.91x**, which will yield a IRR of **26%**.
- For the **Management team**, the Money multiple will be **16.45x**, which will yield a IRR of **59%**.

Note: Please check **Appendix IV.9, IV.10 and IV.11** for another sensitivities and risk analysis.

Exit Strategy | Strategic Sale – Potential Buyers

Biggest firms in the industry are expected to be potential buyers in order to consolidate competitive positions

Potential Strategic Buyers

Name	Country	Public vs Private	Revenues in 2019	EBITDA in 2019	Net Debt /EBITDA in 2019	Description	Comments	Fit
Encompass Health		Listed	$4.6B	$911M	3.26x	• Encompass provides rehabilitation treatment on both an inpatient and outpatient basis. • Its segmentsare: inpatient rehabilitation, home health and hospice.	• Overlap of some healthcare segments. • Increasing cash-flows. • Company's strategy is to expand its inpatient rehab hospitals.	
HCA Healthcare		Listed	$51.3B	$9.8B	3.38x	• HCA provides diagnosis, treatments, consultancy, nursing, surgeries and it also operates psychiatric and rehabilitation hospitals.	• Strong financial performance. • HCA is a big player in the healthcare industry. • Company's strategy relies on expanding in existing markets.	
UHS		Listed	$11.4B	$1.7B	2.30x	• UHS operates as a healthcare management firm. • It provides acute care hospitals (<50% of revenues), behavioral health and surgery centers.	• Overlap of some healthcare segments. • Strong financial performance. • Company's strategy relies on acquiring and consolidating firms.	
Tenet Health		Listed	$18.5B	$2.2B	6.77x	• Tenet operates rehabilitation and specialty hospitals, long-term care, psychiatric and ancillary health care facilities.	• Relevant overlap of healthcare segments. • Acquisition goes in line with future expansion strategy.	

Source: Companies' websites and reports; Bloomberg

Individual Reflection | The Role of Private Equity in Healthcare Industry

For the following years, it is expected that healthcare will guarantee many deals for Private Equity Funds

Select MEDICAL

Past Private Equity Deals in Healthcare

2018
- Private Equity deals rounded c. 800
- Finance businesses with more than $100B

1 *Sectors of interest*
- Retail Health;
- Behavioral Health;
- Free-standing Medical Centers;
- Physician Practice Management.

2 *Healthcare industry attractive factors*
- High fragmentation, as way to gain market power and benefit from economies of scale;
- Health's price-demand is inelastic so valuations remain high;
- Inefficiencies of delivery system;
- Aging population and increasing of chronic illnesses.

Biggest PE deals in Healthcare*

#1	#2	#3	#4	#5
Envision Healthcare	athenahealth	LifePoint Health	Kindred Healthcare	AMR
$9.9B	$5.7B	$5.6B	$4.1B	$2.4B

Significant Trends in Healthcare's PE Deals

1. Higher competition prompt higher valuations
2. Higher valuation prompt creative deal angles
3. Biopharmaceuticals popularity;
4. HCIT popularity;
5. Increased appetite for selected heavy assets

Creative Deal Approaches
- Partnering
- Looking to public markets
- Maintain minority Positions
- Expansion of value-creation theses

Ex. Buy-and-Build, Buy-and-Merge, Commercial Excellence Tactics

Private Equity Investments and Risks Associated

Private Equity firms need high returns → Possible or effective conflict with services' quality and safety

The need for generating significant returns pressures increase of occupancy rates and utilization, incentivize referrals, capture revenues streams and care delivered by unsupervised clinicians.

Colluding in over charging, significant reliance on services provided by unsupervised clinicians, which will affect patients' safety, produce low-value care services and lead to overutilization.

Impact of COVID-19 on Healthcare PE Deals

COVID-19 has accelerated some trends that were already approached as future trends in the past. These trends are related with digital care delivery, virtualization of the healthcare industry, home care and mental health related services, which are perceived with high growth rates.

*as of 2018

Source: Harvard Business Review, HHS Public Access, Bain & Company, Medical Economics, Ernest & Young, Arnold Ventures, Lexology, Forbes

Main Bibliography

- Rosenbaum, J., Pearl, J. 2013. *Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions*. Hoboken, New Jersey: John Wiley & Sons, Inc.
- Select Medical. 2020. *Select Medical's website*. Accessed 4th quarter 2020. https://www.selectmedical.com/
- Concentra. 2020. *Concentra's website*. Accessed 4th quarter 2020. https://www.concentra.com/
- Select Medical. 2015-2019. *Select Medical's Annual Reports*. Accessed 4th quarter 2020. https://www.selectmedical.com/investor-relations/
- MarketLine. 2020. *Industry Profile "Healthcare Providers in the United States*. Accessed October 2020. https://advantage-marketline-com.eu1.proxy.openathens.net/Analysis/ViewasPDF/united-states-healthcare-providers-98202
- McKinsey & Company. 2020. *The financial impact of COVID-19 on health systems and how CFOs are responding*. Accessed October 2020 https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/the-financial-impact-of-covid-19-on-health-systems-and-how-cfos-are-responding
- Cencus.gov. 2020. *Health Insurance Coverage in the United States: 2019*. Accessed October 2020. https://www.census.gov/content/dam/Census/library/publications/2020/demo/p60-271.pdf
- Burns, L. R., DeGraaff, R. A., Danzon, P. M., Kimberly, J. R., Kissick, W. L., Pauly, M. V.. 1998. *The Wharton School Study of the Health Care Value Chain*. Accessed October 2020. https://www.researchgate.net/profile/John_Kimberly/publication/237614717_The_Wharton_School_Study_of_the_Health_Care_Value_Chain/links/00b4953bebd7444c25000000/The-Wharton-School-Study-of-the-Health-Care-Value-Chain.pdf
- Deloitte. 2020. *The role of distributors in the US health care industry*. Accessed October 2020. https://www2.deloitte.com/content/dam/Deloitte/us/Documents/life-sciences-health-care/us-hda-role-of-distributors-in-the-us-health-care-industry.pdf
- Rivers, P. A., Glover, S. H.. 2010. *Health care competition, strategic mission, and patient satisfaction: research model and propositions*. Accessed October 2020. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2865678/
- Viemed. 2015-2019. *Viemed's Annual Reports*. Accessed November 2020. https://www.viemed.com/investor-relations/#financials
- Viemed. 2020. *Viemed's website*. Accessed November 2020. https://www.viemed.com/
- Diversicare. 2015-2019. *Diversicare's Annual Reports*. Accessed November 2020. https://investor.dvcr.com/financials/annual-reports/default.aspx
- Diversicare. 2020. *Diversicare's website*. Accessed November 2020. https://dvcr.com/
- Terillium. 2018. *Benefits of ERP: Advantages, Disadvantages & Selecting an Enterprise Resource Planning*. Accessed November 2020. https://terillium.com/benefits-of-erp/
- Laut, J., Porfiri, M., Raghavan, P. 2019. *The Present and Future of Robotic Technology in Rehabilitation*. Accessed November 2020. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC5461931
- Deloitte. 2020. *2020 global health care Outlook*. Accessed November 2020. https://www2.deloitte.com/global/en/pages/life-sciences-and-healthcare/articles/global-health-care-sector-outlook.html
- McKinsey & Company. 2020. *Seven Healthcare Industry Trends to Watch in 2020*. Accessed November 2020. https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/seven-healthcare-industry-trends-to-watch-in-2020
- Chiron Health. 2020. *Chiron Health's website*. Accessed November 2020. https://chironhealth.com/telemedicine/product/
- Market Data Forecast. 2020. *U.S. Telemedicine Market*. Accessed November 2020. https://www.marketdataforecast.com/market-reports/usa-telemedicine-market
- Federation of State Medical Boards. 2020. *U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19*. Accessed November 2020. https://www.fsmb.org/siteassets/advocacy/pdf/states-waiving-licensure-requirements-for-telehealth-in-response-to-covid-19.pdf
- MHA National. 2020. *Policy Issues*. Accessed November 2020. https://www.mhanational.org/policy-issues
- Medicare. 2020. *Medicare's website*. Accessed November 2020. https://www.medicare.gov/coverage/mental-health-care-outpatient
- Medicaid. 2020. *Medicaid's website*. Accessed November 2020. https://www.medicaid.gov/medicaid/benefits/behavioral-health-services/index.html
- Bloomberg. 2020. *Bloomberg's website*. Accessed 4th quarter 2020. https://bba.bloomberg.net/
- Thomson Reuters. 2020. *Thomson Reuters' website*. Accessed 4th quarter 2020. https://eikon.thomsonreuters.com/index.html